Woman CPA Volume 51, Number 2, April 1989

American Woman's Society of Certified Public Accountants

American Society of Women Accountants

RIL 1989 VOLUME 51, NUMBER 2

MUM'S THE WORD

MAS STRATEGY

AUDIT RISK

The Woman CPA

Editor's Notes

Everybody Benefits: ASWA, AWSCPA, And The Woman CPA

A situation exists that is especially significant to *The Woman CPA* and its sponsoring organizations.

This year, both of the individuals slated for president-elect by the nominating committees of their respective organizations are members of the Joint Committee to Study *The Woman CPA*. For president-elect, the ASWA committee has nominated Gayle Powelson, CPA, controller with Hunter-Melnore in Memphis, Tennessee, while the AWSCPA nominating committee has chosen Maryann Correnti, CPA, an audit manager with Arthur Andersen in Dallas, Texas.

These two young women will bring outstanding capabilities and extensive experience in their organizations to the president-elect positions; more importantly, these two individuals who will be serving their organizations in like positions have worked together for over two years on the Joint Committee to Study *The Woman CPA*. Their work together has not just involved a memo being circulated now and then; they, along with other members of their committee, have met in several extended Joint Committee meetings lasting six to eight hours. As a result, these two young women have established a friendly working relationship marked by openness and cooperation. Neither will have to spend her time as president-elect or president developing rapport, and the climate will be such that jointly sponsored activities will be successful.

In particular, the election of these two young women will be extremely important to the future of *The Woman CPA*. On July 1, the Joint Committee to Study *The Woman CPA* will be replaced by *The Woman CPA* Executive Committee. Each organization has designated a new board position as a two-year term appointment to *The Woman CPA* Executive Committee. With Gayle and Maryann serving as presidents-elect and presidents, it means that for a three-year period, every board member serving on *The Woman CPA* Executive Committee will be reporting on the activities of the committee to a president-elect and then a president who has been involved in the work of the Joint Committee since its formation. This sharing of information and expertise will be crucial to a smooth transition between the two committees and a continuation of the work that has taken place over the past two years.

The continuation of this work is very important to the Joint Committee and to *The Woman CPA*. All of us who have worked on this committee don't want the momentum to be lost, nor do we want improvements in *The Woman CPA* to stop. And with Gayle and Maryann in positions of leadership, the future of *The Woman CPA* looks bright.

Lucian Cunningham Parrish

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The Use Of Audit Committees In Hospitals

By Nancy A. Wagner, Herbert A. O'Keefe, and William J. Bostwick

Editor: Yvonne O. Braune, City of Tacoma, Tacoma, WA 98411

The use of corporate audit committees received renewed emphasis recenty when the report from the National Commission on Fraudulent Financial Reporting [1987, p. 12] concluded that an audit committee "plays a role critical to the integrity of the company's financial reporting" and recommended "that all public companies be required to have audit committees comprised entirely of independent directors."

Previous studies have examined the use of audit committees in municipal governments [Wagner and O'Keefe, 1985-86] and their use in the corporate sector. (The best-known study of audit committees in the corporate sector is that conducted by R. K. Mautz and F. L. Neumann, *Corporate Audit Committees: Policies and Practices*. Cleveland, Ohio: Ernst & Ernst, 1977.) In addition to municipal governments, there are

many other governmental units and non-business organizations that use audit committees. Included in the latter group are hospitals. This study examines (1) the extent to which audit committees are used by hospitals, (2) the composition and responsibilities of such committees, and (3) the perception of the effectiveness of these committees.

Nature of the Study

A questionnaire was mailed to the chief executive officer or chief financial officer of 199 major not-for-profit hospitals in the southeastern United States. The hospitals surveyed included those with 300 or more beds in the states of Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia, and responses were received from 114 hospital officers. The questions posed were designed to determine the number of hospitals with provisions for audit committees, the composition and primary responsibilities of the committees, and the perception of their relative success.

Results of the Study

Extent of Audit Committee Use

According to the 114 respondents, 62 hospitals have established audit committees. Nearly half indicated that the committee is of very recent origin: 29 of the committees were formed in 1978 or later, with 25 of these formed in the 1980's.

Several respondents reported that the audit committee function is performed by the Board's finance committee. Some respondents at hospitals with audit committees said that the committee composition is the same as that of the finance committee. If the respondents indicated that the finance committee functioned as an audit committee, it was counted as an audit committee.

Composition of the Committee

Survey results indicated that a majority of hospital audit committees are composed of three to five individuals. However, as many as twenty of the audit committees studied have six to eight members.

According to respondents, most hospital audit committees have a majority of outside directors and are chaired by an outsider. Unlike audit committees of public companies, hospital audit committees often have inside directors. Respondents reported that 61 percent of the committees have management representation, and in slightly over half of the committees, one of the members is the chief executive officer of the hospital. However, the chairman may be expected to be an outside director since survey results showed 85 percent of the audit committees are chaired by outsiders.

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William J. Bostwick, Ph.D., CPA, *is head of the department of accounting at Georgia Southern College. Dr. Bostwick is a member of the Georgia Society of CPAs and the NAA.*

Of the committees surveyed, 85 percent are made up of members appointed by the Board of Trustees or appointed by the board chairman and then confirmed by the entire board. This method of appointment helps to ensure the committee's independence from management. Only one respondent reported that the chief executive officer, in consultation with the chief financial officer, determines the composition of the committee.

Response to the survey showed that committee appointments are most likely to be for a one-year term but may be renewed an indefinite number of times. In 35 of the committees, annual appointment is the rule; in all but one committee, terms are renewable; and, for more than half the committees, the appointment can be renewed indefinitely. Ten committees had members appointed for a six-year maximum term (either a one-year appointment renewable six times, a two-year appointment renewable three times, or a three-year appointment renewable twice). Other terms of service were limited to periods varying from one year (in one case) to ten years.

Responsibilities of the Committee

According to the respondents, specific duties of the committee usually include

- nomination, selection, and engagement of the independent auditor
- evaluating the results of the independent audit
- evaluating the results of the internal audit

Eighty-three percent of the respondents at hospitals with audit committees reported that selection of the auditor is included among the committee's responsibilities, and 93 percent of the audit committees among those hospitals surveyed evaluate the results of the independent audit. In this respect, the committees conform to the expected emphasis on the external audit function. A smaller number of committees oversee the internal audit function; of those responding to the questionnaire, 61 percent indicated that determining internal audit scope is within the committee's purview, and 78 percent stated that the audit committee evaluates the results of the internal audit.

The survey suggested that these audit committees are less likely to be involved in approving changes in accounting and control systems. Only 52 percent approve changes in significant accounting policies and only 44 percent approve changes in the accounting control system.

Frequency of Meetings

It is generally agreed that an effectively functioning audit committee must meet at least three times a year: once to review the audit plan, once to evaluate audit results, and once to nominate the independent auditor. Any internal audit oversight responsibilities that the committee assumes can also be placed on the agenda for these three meetings. Survey results showed that the majority of hospital audit committees meet at least quarterly, and nearly three-quarters of the committees meet three or more times per year. For the most part, then, the committees seem to meet frequently enough to fulfill their principal responsibilities according to established guidelines.

More than 60 percent of the committees, according to respondents, meet only once with the independent auditor. And, while one-fourth of the committees meet with the internal auditor at least four times during the year, about half meet less often, and several do not meet with the internal auditor at all. Some of the committees meet only once with the entire Board of Trustees, but the majority schedule more frequent meetings, and several arrange such meetings on a monthly basis.

Perceptions of the Committee

The survey indicated that hospitals view their audit committees as making a valuable contribution to the Board's communication with the independent auditor, to improvements in internal control, and to the Board's understanding of and involvement in the financial and accounting policies and procedures of the hospital. Among the positive effects cited by respondents are:

Certified public accountants who serve hospital clients should recommend that consideration be given to the establishment of an audit committee.

Improved communication between trustees/directors and the external and internal auditors. Respondents generally believed that the audit committee contributes to board members' understanding of the financial and operational activities and policies of the hospital and emphasizes the importance of internal control and the significance of audit findings.

Increased likelihood that audit recommendations will be implemented and internal control will be strengthened. Most respondents felt that because the committee is charged with the evaluation of audit results, it is in a position to respond to audit findings and to monitor the implementation of audit recommendations.

Enhanced independence for internal auditors. Respondents focused on improvements in the internal audit function as a primary contribution of the audit committee. In some cases, respondents linked the establishment of an internal audit department to the work of the audit committee.

Survey respondents cited few negative effects resulting from the use of audit committees. However, some of those surveyed were not convinced that committee members had taken enough time to understand the complexities of a hospital financial system and believed that more education was necessary for committee members.

Conclusion

The survey established that the audit committee can contribute to the efficiency and effectiveness of the audit process and can improve the financial information and control systems of hospitals. The evidence clearly suggests that the formation of an audit committee merits increased consideration by hospitals that have not yet adopted the concept. Certified public accountants who serve hospital clients should recommend that consideration be given to the establishment of an audit committee.

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A Message From The Tax Department Editor

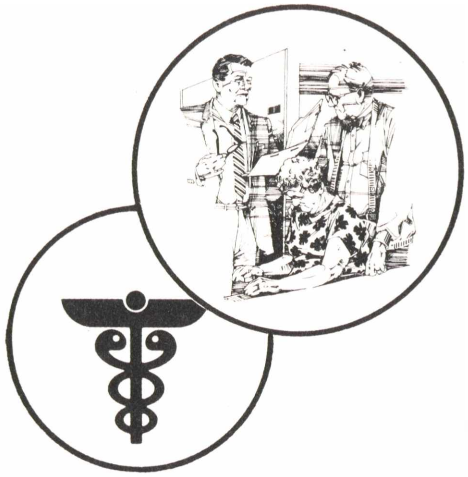
Cherie J. O'Neil
VA Tech, Blacksburg, VA 24061

Tax Department of *The Woman CPA* is a forum for readers to share their knowledge and expertise in taxation. Many of you research tax topics when preparing tax returns for clients and employers, and *The Woman CPA* would like for you to share that research. For example, have you relied on a recent tax case or revenue ruling and feel

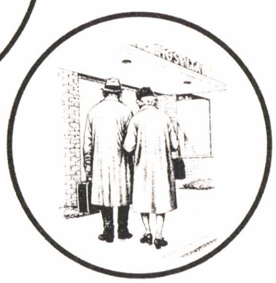
readers could benefit from your experience? Or in complying with the many recent tax law changes, have you discovered an unintended result or a trap for the unwary in one of the new code sections that you think others should know about? Or are there techniques you use in tax planning that you think could be useful to our readers?

If you have never submitted anything for publication, let me briefly review how you should begin. First, make sure your idea is original and one that would be of interest to our readers. Next, outline what you want to say. After you have put your thoughts in a logical order, write your manuscript using your outline as your guide. If what you have written is ten pages or less (double spaced), send it to me for consideration. (If your paper is longer, you may want to consider submitting it for publication as a main article, and in that case, your manuscript should be sent to Dr. Betty Brown, Associate Editor of *The Woman CPA.)* I hope to receive articles from you soon.

Cherie J. O'Neil, Ph.D., CPA, *is associate professor of accounting at Virginia Polytechnic Institute and State University. She formerly worked for the IRS as a revenue agent.*



Exposure Draft of the Health Care Audit Guide: Changes Accountants Can Expect



By Sandra Pelfrey and Barbara A. Theisen

Background

Health care and its related costs have received considerable attention during the last two decades. The dramatic improvement in medical technology has caused many institutional health care providers to invest considerable resources in the latest equipment and facilities. While past expansions were typically funded by operations and donations, the cost associated with staying competitive has necessitated that hospitals and other health care providers enter debt markets with increasing regularity. These borrowings have reinforced the need for annual audits. Since 1972, the AICPA *Hospital Audit Guide* has been the primary authoritative literature that describes how transactions unique to hospitals should be recorded and reflected within their financial statements.[1] Although at times inconsistent

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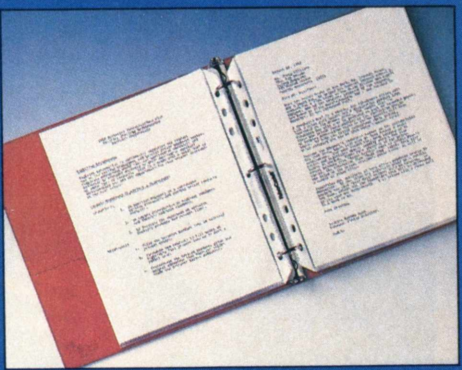

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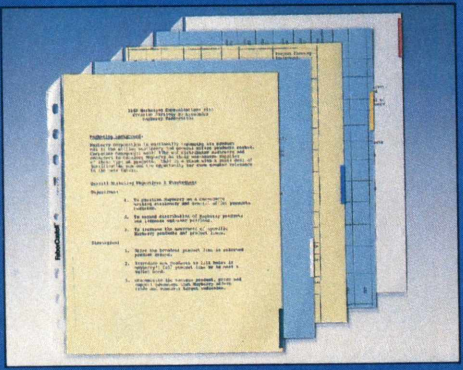

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or unclear on certain issues, the *Hospital Audit Guide*, along with its related Statements of Position, has provided much needed guidance for an industry that continues to expand.

The process of updating the *Hospital Audit Guide* began in the early 1980s. This task has been complicated by the ongoing evolutionary process in which the health care system operates. For example, services are continually shifting from the inpatient to the outpatient arena. Free-standing ambulatory clinics, physicians' groups and health maintenance organizations (HMO) have increased the competition for patients. Furthermore, federal legislation has pressured hospitals to discharge patients at the earliest possible time or to transfer patients in need of custodial care to skilled nursing facilities to avoid losing payment for services rendered. The number of continuing care retirement communities (CCRC) and skilled nursing facilities has increased to meet the needs of the growing population of elderly citizens who require various levels of nursing care. Finally, malpractice concerns plague many physicians and health care entities. Each factor contributes toward the desirability of increasing the financial reporting and auditing requirements of health care organizations.

A joint committee comprised of the Health Care Committee and the Health Care Audit Guide Task Force of the AICPA has completed an exposure draft (ED) of the Proposed Audit and Accounting Guide entitled "Audits of Providers of Health Care Services." The ED is the initial step in the process of replacing the 1972 *Hospital Audit Guide* and the related Statements of Position (i.e., SOP 78-1, 78-7, 81-2, 85-1 and 87-1) that were included in the 1987 edition of the guide. The final version of the new audit guide for health care providers is expected to be issued this year and is not expected to contain any substantive deviations from the ED.

Accounting Principles

One of the major differences between the ED and the existing guide is the increased scope. The ED provides accounting and auditing guidance for hospitals, clinics and other ambulatory care organizations, HMOs, CCRCs, nursing homes, and home health agencies. This expanded scope reflects the diversification and evolution of health care services over the last seventeen years.

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Apart from institutional differences caused by the nature of services provided, health care entities vary by ownership. The three major classifications of owners include 1) not-for-profit, 2) for-profit, and 3) governmental. The sponsorship or legal structure of a health care entity determines the accounting and financial reporting principles that should be followed. All investor-owned and voluntary not-for-profit health care institutions will follow the accounting and financial reporting guidelines in the new audit guide. Those entities that are part of, or sponsored by, governmental units must seek guidance first from the Governmental Accounting Standards Board (GASB). In the absence of a definitive GASB statement, these institutions will adhere to the principles contained in the audit guide, in addition to any other relevant Financial Accounting Standards Board (FASB) pronouncements.

One of the most interesting aspects of the ED is its emphasis on presenting financial information in a manner consistent with a business enterprise rather than that of a not-for-profit entity. Some examples of this include streamlining the balance sheet to reflect a single fund, reporting "net revenues" on the first line of the statement of revenues and expenses, and reclassifying bad debts as an operating expense. Although display within the statement of revenues and expenses still includes the captions "other operating revenue" and "nonoperating revenue," the current guide's inconsistency regarding donated supplies and donated services has been corrected. The ED classifies both of these items together and displays them under the caption "nonoperating revenue."

The ED also addresses risk-based contracts and their related liabilities by providing that any unrecorded costs associated with such contracts be estimated and accrued as contract services are performed. Any anticipated losses are to be accrued in the first period in which they are considered probable and can be estimated. This change will significantly affect HMOs and other preferred provider organizations as well as their independent auditors.

The ED clarifies the methodology for estimating malpractice claims. It reaffirms the guidelines contained in SOP 87-1 which state that industry experience rates should be used to estimate and record anticipated liabilities from asserted and unasserted claims only if the industry rates are relevant to the entity. If a health care provider's operations and overall risk potential differ significantly from the industry average, the individual entity's experience rate should be used.

The ED identifies the unique accounting transactions and reporting requirements of nonhospital health care providers. Such items include estimating the liability for future services for nursing homes and CCRCs whose residents may have contracts that specify fixed fees and/or fixed incremental rates. Similar liabilities exist for HMOs whose fees may not cover the expected costs of future services.

Finally, the ED provides examples of financial statements for hospitals, nursing homes, CCRCs, home health agencies, HMOs and ambulatory care facilities. These illustrations include cash flow statements and statements of changes in fund balance. The cash flow statement is not in full compliance with SFAS No. 95, "Statement of Cash Flows," since SFAS No. 95 specifically applies to for-profit companies. (An AICPA task force has been formed to analyze SFAS No. 95 to determine its potential impact on the not-for-profit reporting community.)

Auditing

The ED addresses specific auditing concerns common to the health care industry, one of which is the confirmation of patient accounts receivable. Because direct confirmation of patient accounts receivable is often impractical, the ED outlines alternative procedures (e.g., reviewing subsequent payments, reviewing insurance company billings and payments, or examining the patient's medical record) that auditors may use to support accounts receivable balances.

Another auditing concern relates to verifying receivables from third-party insurance carriers. The complexity and variability of third-party reimbursement arrangements require auditors to know which and to what extent each reimbursement arrangement is being used by their audit client. Although audit procedures will differ by reimbursement method, one procedure should be a review of the system that assigns patients to specific insurance carriers. Included also should be procedures for reviewing final cost settlement reports for retroactive reimbursement methods or for reviewing methods of determining diagnosis for discharged patients.

Other audit procedures outlined involve the support and proper disclosure of restricted donations and related party transactions, which must be reviewed for compliance, propriety, and fair presentation.

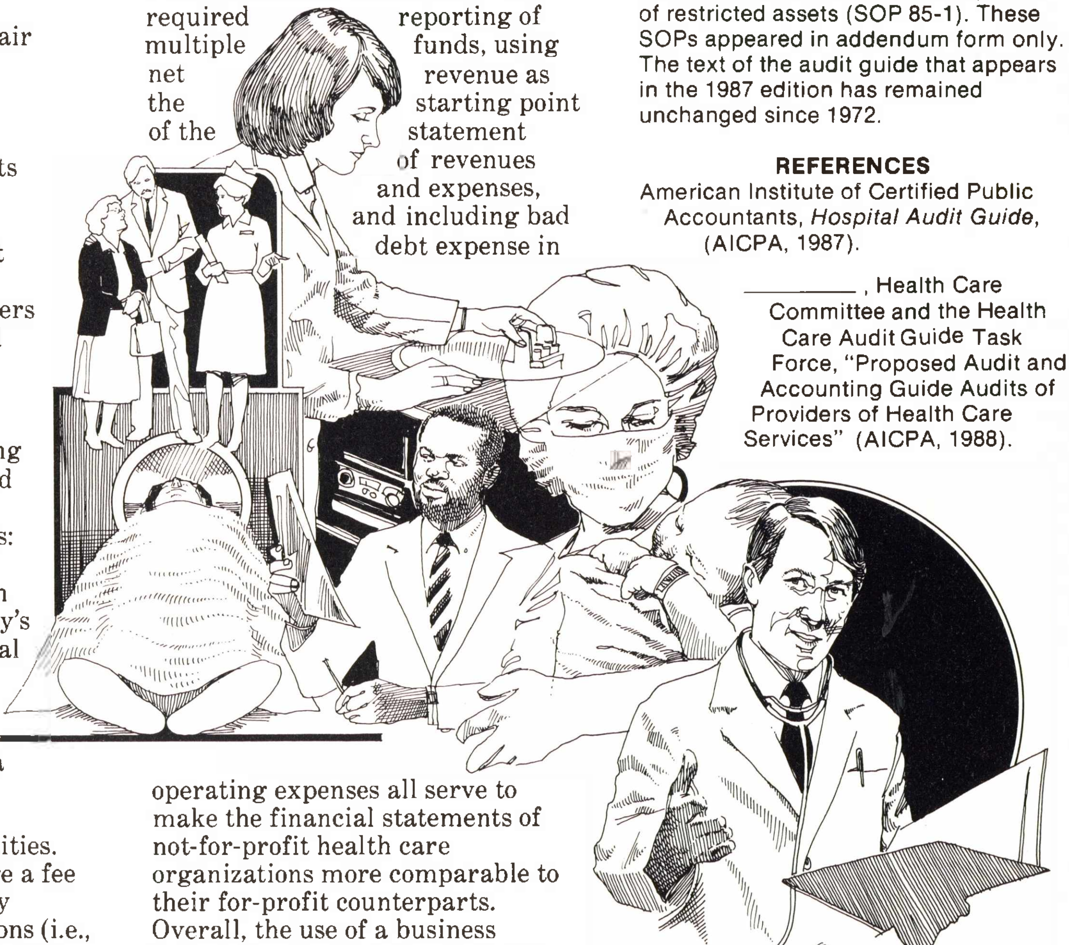
Impact of the ED

The ED not only extends its scope to nonhospital health care providers, but also lends credence to the concept that not-for-profit hospitals and other health care providers are and should be considered businesses. By streamlining the financial statements and formally accepting the generally accepted accounting and reporting principles used by business enterprises, the ED acknowledges two things: 1) the entity's need to make a profit in order to remain in existence, and 2) the industry's need for comparable financial statements regardless of an entity's ownership and/or sponsorship.

There will continue to be a relatively small number of hospitals that can truly be classified as nonbusiness entities. These hospitals do not charge a fee for service and are primarily supported by private donations (i.e., Shriners Hospitals). The ED does not specifically address these nonbusiness entities.

Conclusion

When finalized, the new audit guide will significantly affect the accounting and reporting requirements of most health care entities. Expanding the scope to include nonhospital providers, updating the treatment of revenues and risk-based contracts, and clarifying matters such as the treatment of malpractice loss contingencies provide long-needed guidance. Also significant is the shift in financial statement presentation from a nonbusiness to a business focus. Eliminating the required reporting of multiple funds, using net revenue as the starting point of the statement of revenues and expenses, and including bad debt expense in operating expenses all serve to make the financial statements of not-for-profit health care organizations more comparable to their for-profit counterparts. Overall, the use of a business format in reporting the financial operations of a not-for-profit entity will underscore the reality that health care organizations are, in fact, businesses. Auditors will need to restructure their audits to respond to the changes and to meet the auditing objectives set forth in the ED.



FOOTNOTES

[1]Subsequent editions of the *Hospital Audit Guide* have included Statements of Position (SOP) on topics that affect not-for-profit entities. The SOP topics have included estimating malpractice loss contingencies (SOP 78-10 and 87-1), accounting for marketable equity securities (SOP 78-1), and reporting for tax-exempt debt and funds comprised of restricted assets (SOP 85-1). These SOPs appeared in addendum form only. The text of the audit guide that appears in the 1987 edition has remained unchanged since 1972.

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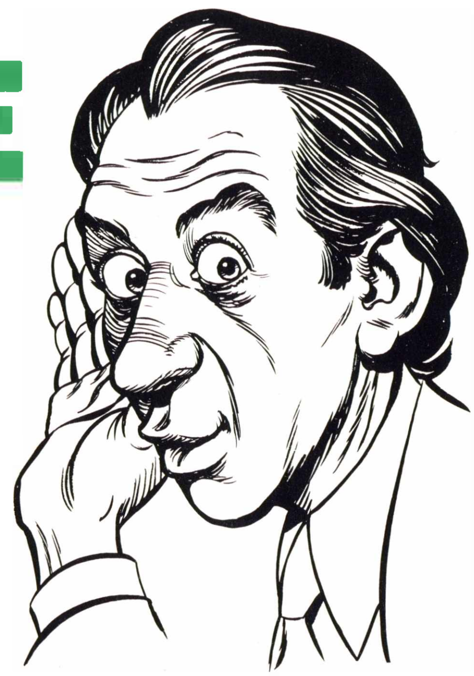


— OR IS IT? —

A Potential Conflict In Auditing And Legal Standards

By Danny L. Kennett and William J. Radig

The independent auditor's duty to disclose management misconduct to third parties is an extremely sensitive area involving both auditing standards and legal standards of conduct. It has been generally argued that the auditor's duty to disclose ended when the auditor notified the client of management misconduct and subsequently withdrew or disassociated himself or herself from the client [Chazen, Miller, and Solomon, pp. 66-70]. Proponents of this argument contend that silent withdrawal is a privilege of the auditor/client relationship and is necessary because of the auditor's unique relationship between a client and the public. Moreover, it has been pointed out that there is no basis in generally accepted auditing standards or legal theory to suggest that anything other than silent withdrawal is appropriate. While, under certain circumstances, the auditor may be legally justified in disclosing misconduct to third parties, the auditor is not legally obligated to blow the whistle.

SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, one of the "expectation gap" pronouncements, generally endorses the silent withdrawal argument. It states, in part [paragraph 29]:

Disclosure of irregularities to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and would be precluded by the auditor's ethical or legal obligation of confidentiality unless the matter affects his opinion on the financial statements. The auditor should

. . . there is no basis in generally accepted auditing standards or legal theory to suggest that anything other than silent withdrawal is appropriate.

recognize, however, that in the following circumstances a duty to disclose outside the client may exist:

a. When the entity reports an auditor change under the appropriate securities law on Form 8-K
b. To a successor audit or when the successor makes inquiries in accordance with SAS No. 7, . . .
c. In response to a subpoena
d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing irregularities with parties outside the client.

The Statement clearly proscribes disclosures to third parties other than those specifically mentioned and cautions the auditor to consult legal counsel prior to notification of such parties. In short, unless otherwise directed by auditing standards, the auditor should remain silent upon withdrawal. Apparently, this policy is required, in part, by the auditor's "legal obligation of confidentiality."

Nevertheless, the auditor may, under certain circumstances, have a legal obligation to disclose management misconduct to third parties other than those specified in SAS No. 53. Causey [1986, p. 1-11] notes that a "relatively new line of court decisions is moving accountants and other professionals to a standard of conduct involving *mandatory disclosure of client misconduct*." Accordingly, he cautions [p. 7-5]: "Where the CPA learns that the client is misleading or attempting to mislead others, the CPA should consult legal counsel as to whether the factual setting permits withdrawal in silence."

Emerging Legal Standard of Conduct

Although SAS No. 53 is authoritative and provides explicit guidance concerning silent withdrawal stemming from management misconduct, its comfort may be more apparent than real. While courts consider a profession's accepted standard of conduct, they clearly are not bound formally or informally by that standard. Moreover, common law is subject to modification, revision, interpretation, and rejection by courts over time. Consequently, auditors should be aware of emerging legal standards of conduct that may conflict with or extend the profession's standards.

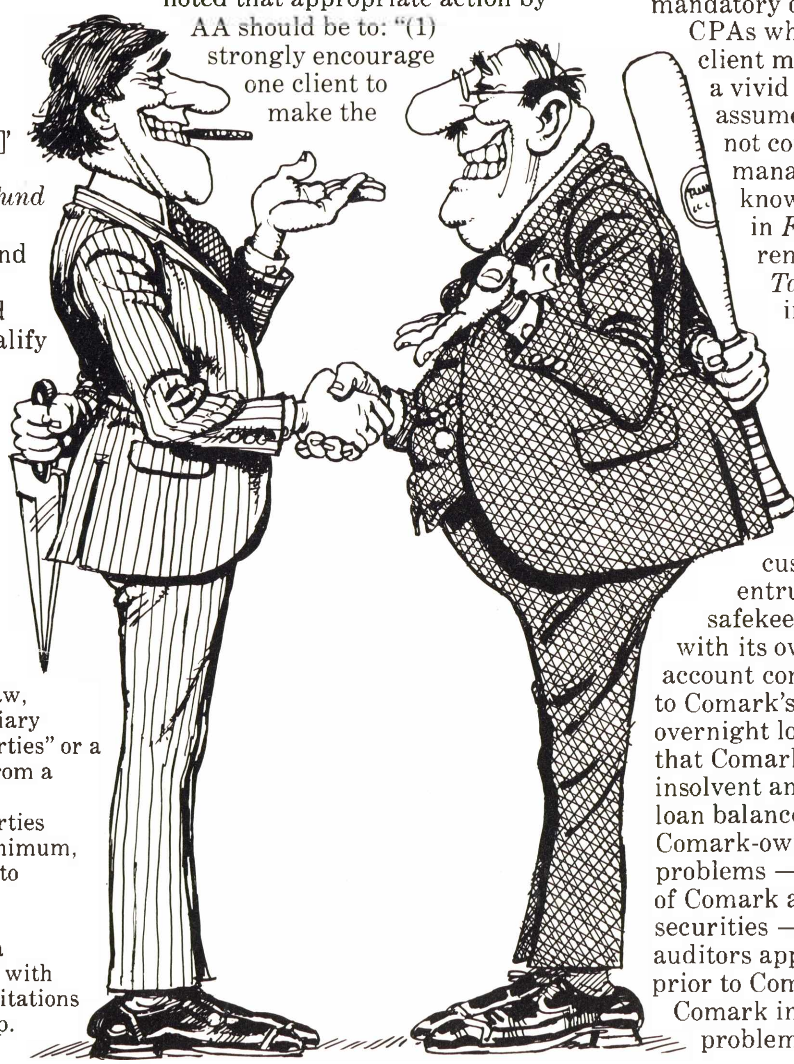
Tarasoff v. Regents of University of California and *Fund of Funds, Ltd. v. Arthur Andersen & Co.* are two cases in the "relatively new line of court decisions" Causey notes. In *Tarasoff*, a psychotherapist, during therapy, was informed by a patient of his intent to murder a person whose identity was readily

While courts consider a profession's accepted standard of conduct, they clearly are not bound formally or informally by that standard.

determinable. The victim was not warned, and the threat was carried out by the patient. The victim's parents sued. The court noted the need for, and protection of, the confidential psychotherapist-patient relationship. The court also noted the common law rule that one person does not have a duty to warn those endangered by another's conduct except when the person stands in some special relationship to the perpetrator and/or the intended victim. However, the court held that the psychotherapist owed a higher legal duty to inform the victim of the imminent danger than to maintain the patient's threats in confidence.

Causey also cites *Fund of Funds* in his discussion of recent court decisions, yet the implications of this case remain somewhat ambiguous because there was no third party and the CPA firm was associated with materially misstated financials. The *Fund of Funds* case involves three parties: the King group of companies (King), Fund of Funds (FOF), and the CPA firm of Arthur Andersen & Co. (AA), who was the external auditor for both King and FOF. Briefly, FOF entered into an agreement with King, whereby King was to advise FOF on the purchase of oil and gas properties and sell such properties to FOF at "arm's length" prices from its own inventory. However, King's relationship was described in the minutes of a Board of Director's meeting as 'essentially a discretionary account managed by [King]' and by AA as a 'quasi fiduciary' duty to FOF." [*Fund of Funds*, p. 1334]. In fact, King fraudulently sold oil and gas properties at inflated prices to FOF. AA detected the practice but did not qualify its reports on the financials of King or FOF nor inform FOF of the fraud. The court explained that failure to disclose material information may be a basis for fraud:

> Non-disclosure of material information, or omissions to disclose matter necessary to make other representations not misleading, are also actionable under common law, provided "there was a fiduciary relationship between the parties" or a duty of disclosure arising from a "relationship of trust and confidence" between the parties [citations omitted]. At a minimum, a claim of fraud for failure to disclose may be based on defendant's knowledge that plaintiff was acting under a reasonable, mistaken belief with respect to a material fact [citations omitted] [*Fund of Funds*, pp. 1359 and 60].



The court held that AA failed to disclose King's fraud to FOF "despite a professional duty and an express contractual obligation to do so." [*Fund of Funds*, p. 1360] AA's engagement letter to FOF provided that *"any irregularities coming to our attention would be reported to you immediately"* [*Fund of Funds*, p. 1327]. The court also rejected AA's claim that its knowledge of King's activities was confidential information. Even if the information was confidential, the court, citing expert testimony, noted that appropriate action by AA should be to: "(1) strongly encourage one client to make the necessary disclosure; (2) disclose that it has relevant information not available to the other client; or (3) resign from one account" [*Fund of Funds*, p. 1361]

First Fed. Sav. & Loan v. Oppenheim, Appel. Dixon

Does the auditor have a duty to warn the victims if there is imminent danger of financial loss to known third parties? Although *First Federal* does not establish precedent, it clearly reveals the court's predisposition to enforce a mandatory disclosure standard for CPAs who become aware of client misconduct. It is also a vivid example of the risks assumed by a CPA who does not consult legal counsel when management misconduct is known. The factual setting in *First Federal* is remarkably similar to *Tarasoff*. Both cases involve defendents having professional confidentiality relationships and third party victims. In *First Federal*, the auditors were informed by their audit client, Comark, that its customer-owned securities, entrusted to Comark for safekeeping, were comingled with its own securities in an account controlled by and pledged to Comark's bank/clearing agent for overnight loans. The auditors knew that Comark was technically insolvent and that the overnight loan balance exceeded the value of Comark-owned securities. Both problems — the financial difficulties of Comark and the comingling of securities — were known by the auditors approximately a year prior to Comark's collapse. When Comark informed its bank of both problems, the bank immediately

It is obvious that CPAs should consult their own legal counsel to determine if the factual setting permits withdrawal in silence.

foreclosed on the loan and liquidated all securities held in the pledged account. This event occurred approximately five months after Comark's year-end. However, financial statements, at least statements with which the auditors were associated, were never issued.

Plaintiffs — customers who lost their securities entrusted to Comark for safekeeping — alleged two negligent misrepresentations by the auditors. First, with knowledge to the contrary the partner-in-charge verbally assured a Comark salesperson that there should be no problem with the year-end financials.

Second, customer-owned securities held in "safekeeping" by Comark were confirmed directly with the customers in two separate mailings as part of the year-end audit procedures. Customers were requested to "please confirm directly to our auditors . . that the attached statements are a complete and accurate record of . . . all securities we are holding for you in safekeeping," which the courts viewed as "impliedly, but effectively representing that the writer or sender believes the securitiese are indeed being held in safekeeping" [*First Federal* p. 436]. Plaintiffs argued the confirmations were "*affirmative* negligent misstatements of fact" by the auditors rather than a failure to disclose certain facts.

The oral misrepresentation had little, if any, effect on the court's decision. The second alleged misrepresentation formed the crux of the case. The court held: "Certainly, once [the CPA firm] communicated with the plaintiffs, it owed them a duty to speak truthfully" [*First Federal*, p. 435]. In addition, the *First Federal* court [p. 434] held that the confirmations were "financial reports" in applying the *Credit Alliance* criteria. Under a complex web of legal theories, the auditors were successfully sued for violations of RICO, common law negligence, and common law fraud.

Could liability have been avoided if the auditors had withdrawn from the engagement in silence before direct confirmations were mailed to the customers? The court did not have to address this question, nor did it have to address the auditor's defense that they owed a "higher legal duty" not to disclose detrimental information obtained in the confidential auditor-client relationship. Nevertheless, the court chose to comment on the confidentiality issue. Its comment makes it clear that in the court's view, it was the auditor's duty to disclose at some point in time prior to the direct confirmations.

> It should be noted moreover that given the allegations of [the auditor's] awareness of Comark's insolvency, Comark's fraudulent hypothecation of its customers' securities, and the immediate danger of devastating financial losses plaintiffs risked by continued association with Comark, [the auditors] may well have had a duty to disclose. It is an accepted proposition in the area of common law fraud that a claim for deceit based on a failure to disclose may be based on a defendant's knowledge that a plaintiff was acting under a reasonable, mistaken belief with respect to a material fact (citations omitted) [*First Federal*, p. 435, note 7].

Does the auditor have a duty to warn the victims if there is imminent danger of financial loss to known third parties?

Immediate danger and imminent danger, like other legal and auditing concepts, defy precise definition. In *First Federal*, Comark's severe financial difficulties, unless corrected, assured third party losses: either the customers would lose their securities or Comark would default on its loan.

There is one final aspect of this case that merits mention. The CPA firm was clearly aware of a legal hazard. However,instead of consulting their legal counsel, they consulted and apparently relied upon the advice of Comark's counsel. Subsequently,the CPA firm brought suit against Comark's legal counsel [*First Fed. Sav. & Loan v. Oppenheim, Appel, Dixon*, 634 F. Supp. 1341 (S.D.N.Y. 1986)]. This action is still unresolved.

Summary and Conclusions

New auditing standards and emerging legal standards of conduct may be on a collision course regarding withdrawal in silence when management misconduct is involved. SAS No. 53 categorically states that disclosure to outside parties "would be precluded by the auditor's ethical or legal obligations of confidentiality" unless the auditor is associated with financial statements and other specific circumstances. In contrast, a relatively new line of court decisions suggests that auditors may have an affirmative duty to disclose client misconduct when identifiable third parties are in imminent or immediate danger of devastating financial loss.

It is obvious that CPAs should consult their own legal counsel to determine if the factual setting permits withdrawal in silence. *First Federal* also demonstrates that CPAs should consult their own legal counsel before communicating either directly or indirectly with third parties who are or may be affected by management misconduct.

SAS No. 53 may have little impact on the profession, other than to raise a flag of caution. Auditors who find themselves pondering their duty to disclose management misconduct will be influenced more by the advice of their attorneys than by advice offered in the professional standards. Perhaps this is the way it should be in the matters of errors and irregularities, since litigation is both probable and prevalent in such matters.

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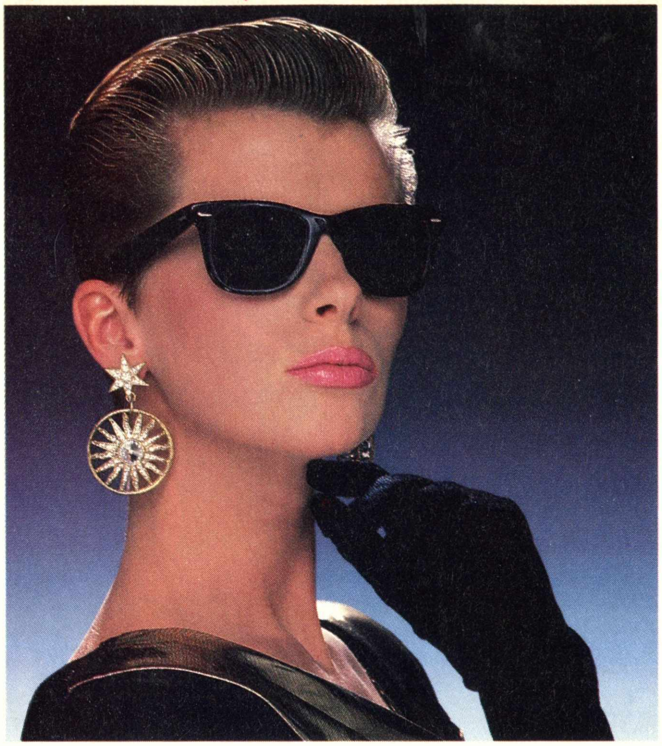

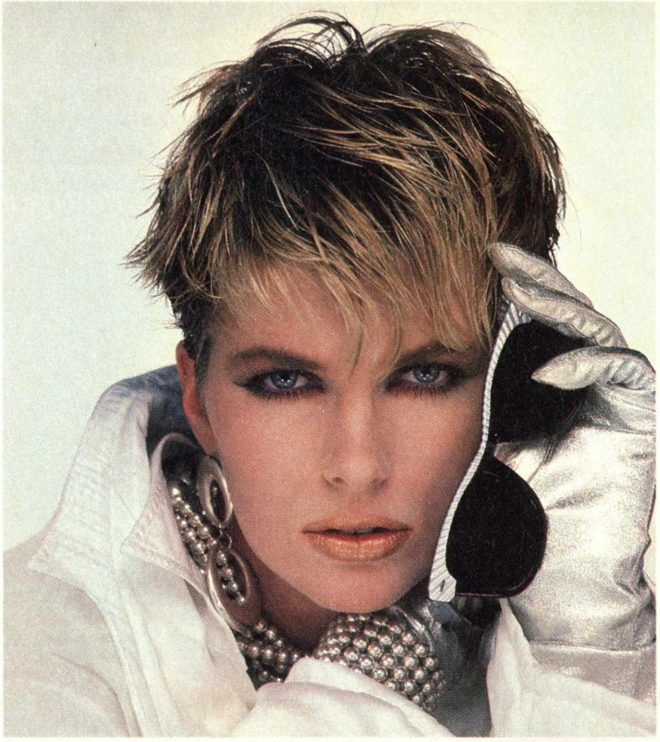

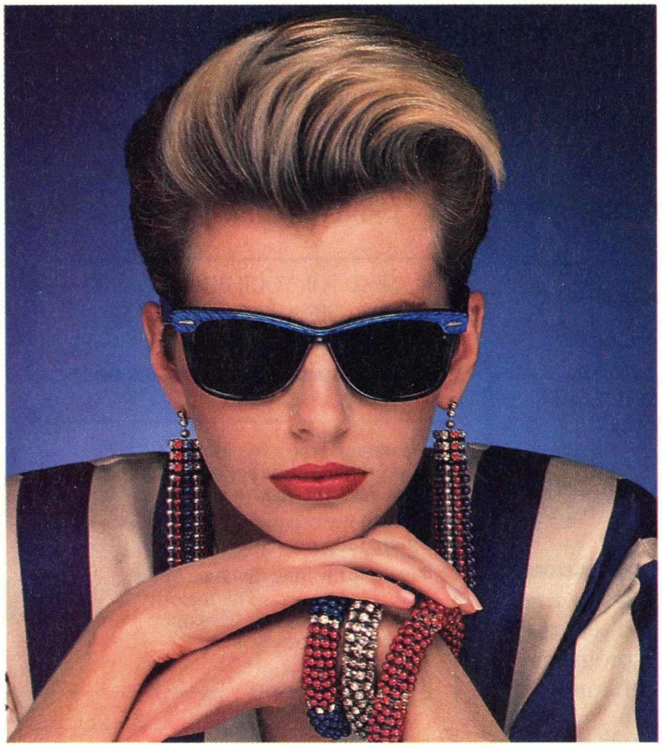

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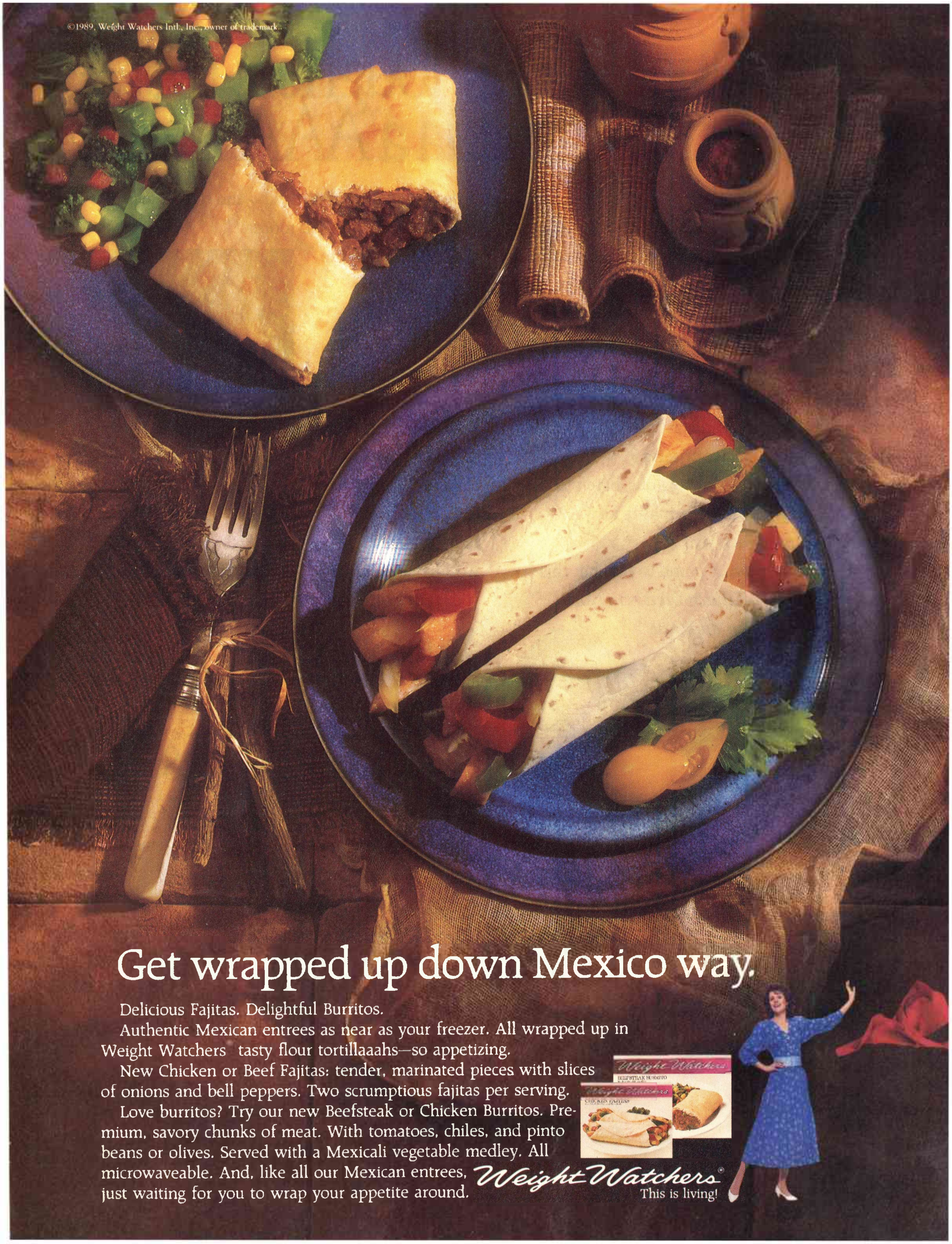

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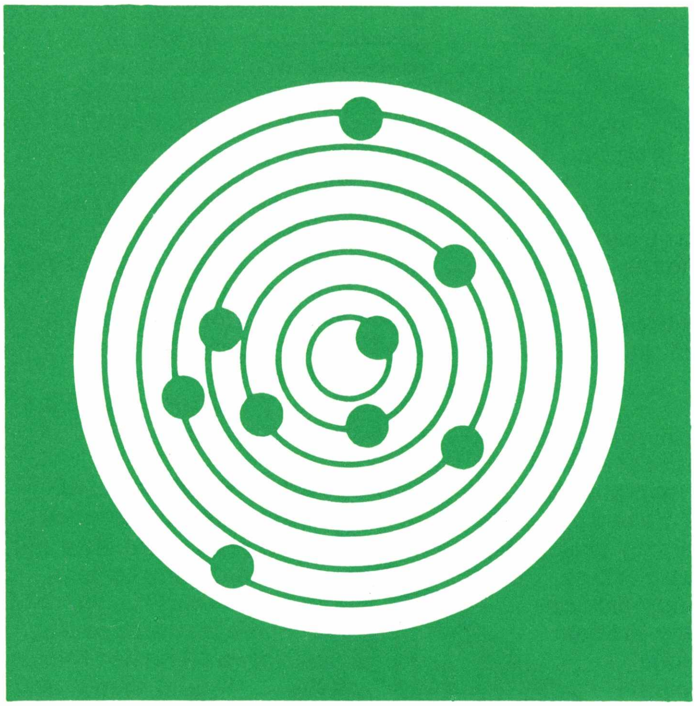

Make the Education Department the TARGET

Editor: Roland L. Madison,
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WRITING FOR THE EDUCATION DEPARTMENT

The purpose of this article is twofold. The first is to describe the scope and nature of the Education Department. The second is to provide some topical areas where contributions would be welcome during the coming year.

The scope of the Education Department is quite broad. We are seeking articles that, from an educational standpoint, have relevance and appeal to persons who are engaged in industry, public accounting, academia, and various areas of not-for-profit accounting practice.

Many of the problems and concerns faced by business are common to all areas of accounting practice. Problems exist in the development of leadership models, in communication skills, and in computer literacy. Also, there are concerns about the role that ethics plays in all facets of business today. Some would argue that the origin of many of these problems lies with an American educational system that lacks quality and strategic direction when compared to other cultures and to the phenomenal costs we have invested in education. Others would not seek to assign blame for the many problems commonly faced by accountants in business, but would prefer to seek solutions that involve cooperation, role assignments and corrective action between business and the educational community.

It is articles that deal with topical issues within these broad boundaries that we hope will appeal to the readers of the education column of *The Woman CPA*. Literary contributions from our readers who are involved in all areas of accounting, in addition to those who are involved in the academic community, are necessary to provide a breadth and appreciation for the professional concerns and potential solutions that all of us may find of value.

Potential Topics For The Education Department

There is currently a wide variety of topics pertinent to professional accounting education which may be of interest to our readers. Authors are invited to evaluate the partial listing of topics which follows and develop an article related to one of these topics, or to related topics that are relevant to accounting education — either in terms of education for today, or for educational issues that relate to the future of accounting.

• **CMA versus CPA.** Does industry actively promote the CMA program? Is the program a success — or is the CMA often regarded as a certification secondary to the CPA? Will specialization testing and certification by the AICPA enhance the status of the CMA certificate?

• **Career development.** How well does our educational system prepare persons for non-public accounting careers? Have we established the necessary programs and provided adequate career counseling for the sixty percent-plus of our accounting graduates that do not enter public accounting? Do corporate accounting personnel perceive the lack of industrial/corporate accounting tracks in higher education to be a problem?

• **Personality traits and turnover in accounting firms.** Would pre-college testing or campus career counseling provide the best solution? Are accounting firms evaluating the relevant characteristics in new hires to minimize turnover?

• **Merits and problems of the 150-hour accounting education requirement.** Did Beamer, Bedford, Anderson — or you, the AICPA member — seriously count the costs of extending accounting education another full year? What will be the impact upon students in general, upon minorities in particular, upon educational institutions, accounting firms and their clients, or upon society? Was this proposal seriously considered by all constituencies or was its passage by the membership the greatest promotional hype in the history of modern-day accounting? Is the five-year education experiment in Florida a Boom or a Bust — or is it perhaps accomplishing the long-run strategy of a particular segment of the accounting profession?

• **Separate accreditation of accounting programs.** What are the benefits and costs to those who have done it versus the views of those institutions who have discarded the idea and even closed their fifth-year programs for lack of enrollment? What are the implications for the AICPA and the year 2000?

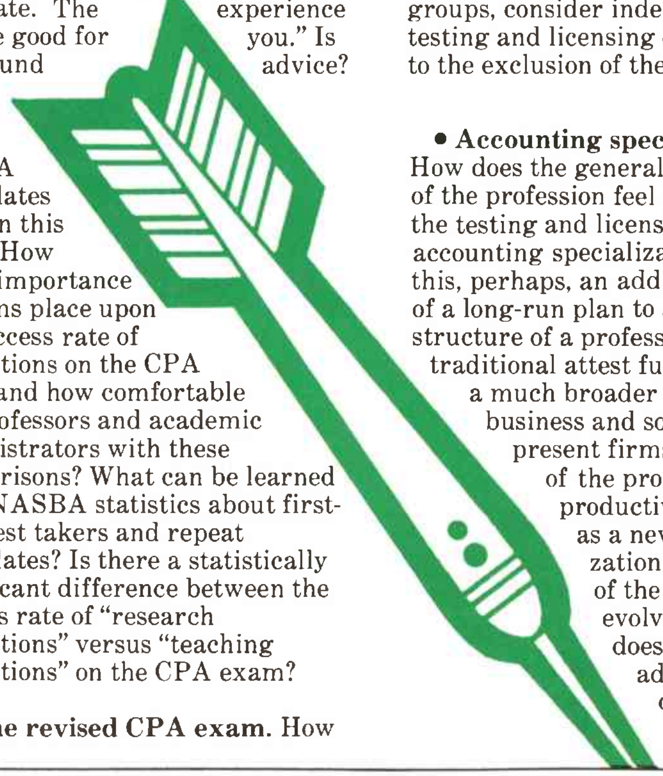
• **Potential employers' view of the preparation of today's accounting graduates.** Are the traditional criticisms still present or have new ones taken their place? Are there deficiencies in the areas of communications and computer literacy, among others?

• **Business ethics, production operation management, artificial intelligence, and internationalization of the undergraduate accounting programs.** How to accomplish all this? (in four years?) Is it necessary for programs to expand to include these areas? Where these feats have been acheived, what, if anything, was given up to add the new material to the traditional undergraduate program?

• **Measuring effective teaching.** Is it really important to excel in the classroom today or only on the printed page? What do practitioners and academics feel about what some believe is a diminution of value placed upon teaching quality and professional service activities often used by academics to bring business reality into the classroom?

• **Accreditation standards.** Do they promote or impair the development of strong practitioner and academic interactions through faculty residencies? What are the costs, benefits and problems for firms, educational institutions, and the persons directly involved in such programs?

• **The CPA exam.** "Take the CPA exam as soon as you graduate. The experience will be good for you." Is this sound advice? What views do CPA candidates have on this issue? How much importance do firms place upon the success rate of institutions on the CPA exam and how comfortable are professors and academic administrators with these comparisons? What can be learned from NASBA statistics about first-time test takers and repeat candidates? Is there a statistically significant difference between the success rate of "research institutions" versus "teaching institutions" on the CPA exam?



• **The revised CPA exam.** How do practitioners and educators view the new look for the CPA exam (1990-1992)? Do the changes in the new exam format diminish the opportunities to evaluate logical thinking, organizational skills and communication proficiencies? Or do they allow for more topical areas to be covered — in a more economical fashion? Where do the rank and file members of the Institute stand? How does academia view this change? If this project is implemented as scheduled, will any states supported by specific interest groups, consider independent testing and licensing of accountants to the exclusion of the AICPA?

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• **Accounting specializations.** How does the general membership of the profession feel about the testing and licensing of accounting specializations? Is this, perhaps, an additional aspect of a long-run plan to alter the structure of a profession from the traditional attest function to one of a much broader scope within business and society? Will all present firms and members of the profession be productive participants as a new organizational structure of the profession evolves? How does the potential admission of non-CPA professionals into the Institute and the modification of the CPA exam with the possibility of certified specializations fit into the long-run strategic goals of the accounting profession? Do we have a coordinated purpose and direction for these various changes in the profession?

Conclusion

From the preceding list, it should be apparent that many issues and opportunities exist for research into professional accounting. Some issues relate not only to the present but significantly to the future of accounting education and the profession. Just as the accounting profession is apparently in a state of rather rapid evolutionary change, those involved with accounting education either directly or indirectly must realize that academia is a functional part of the accounting enviornment and thus must be prepared to evaluate and adapt to changes in the enviornment. That is why it is important that accountants in industry, accountants in public practice firms of all sizes, and those in academia take the opportunity to communicate their professional concerns for the improvement of the accounting profession. That improvement is the role of accounting education, and the purpose of this column in *The Woman CPA* is to provide a communication vehicle for those who wish to constructively participate in the improvement of the accounting profession.

Putting Together A Firm-Wide MAS Strategy

By Wayne Bremser and Jiunn C. Huang
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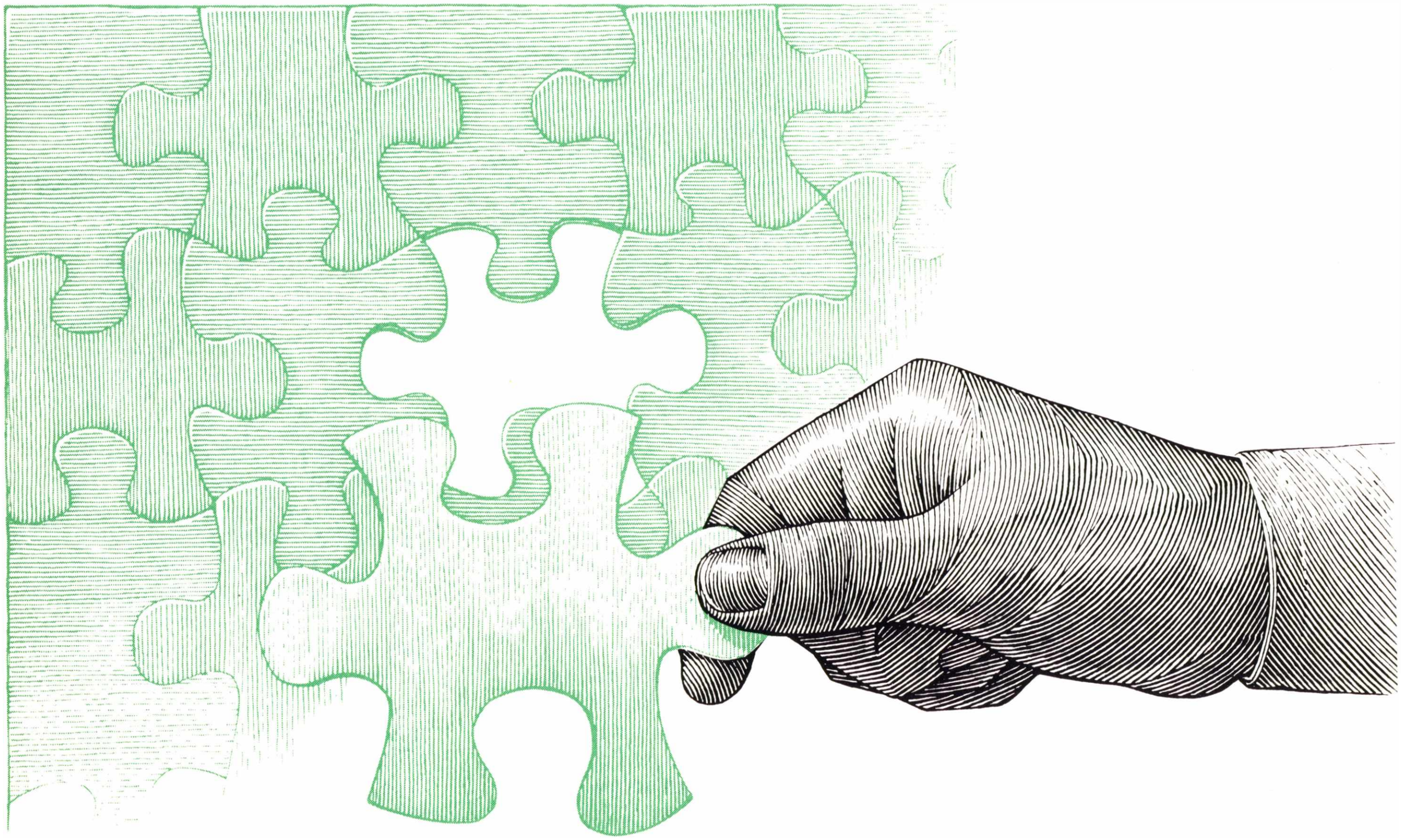
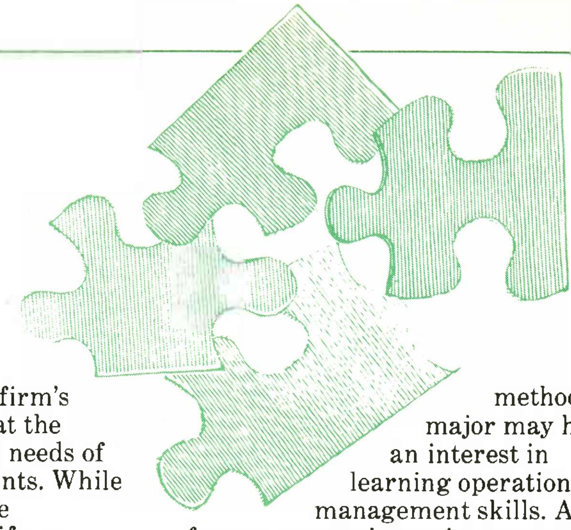


Intense competition in the traditional service areas — accounting, auditing, and tax — has caused many CPA firms to look elsewhere for growth opportunities. Management advisory services (MAS) are a natural extension of accounting, auditing and tax services. Oftentimes, MAS engagements arise because need is identified when accounting or auditing services are provided. An expansion-minded CPA firm should look beyond these obvious MAS opportunities and develop a deliberate strategy to market MAS which is likely to be more profitable than an unplanned effort.



Basic Strategy

By devising and following a long-range plan for an orderly expansion of services, firms can efficiently develop their capabilities. The starting point for devising such a plan is to assess the profit potential of MAS opportunities.

What are those opportunities? To answer this question, a list of MAS opportunities was developed from a review of the MAS promotional brochures issued by national CPA firms. These documents explain the firms' MAS capabilities to potential clients. The listing in Exhibit 1 evinces the wide range of offerings.

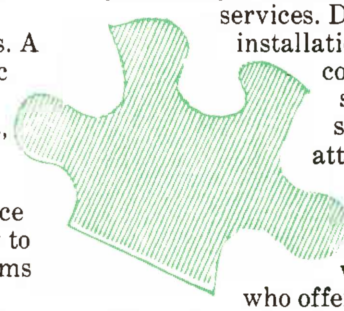
From Exhibit 1, it is obvious that services such as designing and implementing general and cost accounting systems, cash and working capital management, internal and budget control, and profit and financial planning are closely related to accounting and should be a natural extension of accounting and auditing services. A firm's existing staff has the basic knowledge and qualifications needed to perform these services, and costs for additional training and related investments to offer these services should be low. Since these services are relatively easy to offer, competition from other firms is likely to be strong.

A strategic move to specialize in selected MAS categories is the path to a more profitable MAS practice. Exhibit 1 lists many opportunities. However, these opportunities can become pitfalls. To evaluate the profitability of the various opportunities, a profit potential assessment based on market attractiveness and the firm's competency potential to provide services should be made.

Market Attractiveness

Market attractiveness is determined by the business environment in the CPA firm's market area. First, look at the current annd prospective needs of audit and accounting clients. While keeping the independence constraint in mind, identify an initial list of potential services. The current client relationship makes these services the easiest to sell.

Second, revise this initial list by adding other services that seem attractive for the market area. Third, evaluate market size and growth for the services on the revised list by looking at business trends in the market area. For example, if growth is in service industries, MAS offerings oriented toward these clients are most promising. Developing consulting capabilities to serve firms in the growth sectors of the local economy may eventually lead to new audit clients. Fourth, look at the intensity of competition among current and potential providers of the various services. Design and installation of computerized systems may seem to be an attractive market, but many market areas are saturated with consultants who offer these services.



The end result of this analysis should be a list of potential MAS opportunities ranked by market attractiveness.

Competency

After the initial ranking, the firm's competency to provide these services should be evaluated. Large firms can hire people with the necessary skills. In smaller firms, the skills and interests of the firm's staff must be evaluated. A basic interest in a promising service area should not be underrated. A former mathematics or quantitative methods major may have an interest in learning operations management skills. A former economics major may want to work with clients on forecasting market demand for products. If staff personnel have a basic interest in a type of service, investment in developing specific skills may be worthwhile.

The investment in time, tuition, books, equipment, computer software, and materials required to attain the necessary level of competency should be estimated. Likewise, the cost of maintaining competency should be considered since some specialties require substantial continuing investments in training and equipment. If these investments are substantial, the competency potential rating should be downgraded.

Care must be exercised in assessing the investment. For example, tuition costs for maintaining competency may not be a relevant cost if 40 hours per year of continuing professional education are required, and there are no other pressing education needs for the particular individual. Also, the individual's long-run commitment to the firm is a factor in assessing the investment. Someone having five years with the firm and outstanding partnership potential would be worth a significant investment if the potential payoffs are MAS fees for the firm and job satisfaction for the individual.

The competency evaluation process will usually result in a revised ranking of the market attractiveness list of potential MAS offerings. For example, a service previously ranked first according to market attractiveness might now be fifth because the firm's compentency potential is only

moderate. A second look at market attractiveness and competency might result in further revisions of the rankings.

Commitment

As a result of these assessments, a final ranking emerges, and a firm can make a commitment to provide the top-ranked services. Initially, the plan might be to offer and promote the top three or four services on the list. In subsequent years, the firm's offerings could move down the list.

The firm's rankings may change as market attractiveness and competency factors change. Two factors that may significantly affect a firm's long-range planning and MAS expansion opportunities are computer technology and expert systems.

Computer Technology and Opportunities

The fast growth in computer technology — minicomputers, microcomputers, word processors, photo composers, and new communication techniques — has created ample opportunities for new advisory services. Typical types of services related to computers, as shown in Exhibit 1, include information needs analyses, feasibility analyses, systems design and implementation, hardware and software selection, office automation, and data security reviews. Performance of these services requires specialized knowledge and expertise in the computer information systems area.

Staff with EDP auditing experience may be able to use self-study methods to develop the skills needed for the firm to offer computer services. Others less competent in computers but willing to learn would require formal continuing professional education.

A firm's investment in computer training promises a dual payoff. As costs of computing equipment and accounting software continue to fall, clients will expand their appetites for these items. With a competent staff, a CPA firm can advise a client on hardware and software acquisitions. Besides earning MAS fees, when the time comes to provide accounting and auditing services, the potential for unpleasant surprises from a newly installed computer system is diminished.

Although providing computer consulting services will probably require additional investments in facilities, equipment, and staff, the opportunities for services to clients on an ongoing basis will continue to expand. For example, if a CPA firm has a specialty in a specific area such as health care, it may develop a general purpose cost allocation electronic spreadsheet template to be used by its clients. Similarly, if a firm is strong in a specific application such as budgeting and financial modeling, general templates can also be developed for these applications.

Expert Systems

Any discussion on opportunities of MAS arising from high technology would be incomplete without considering the development of expert systems. An expert system is a set of computer programs that has the knowledge and capacity to operate at the expert level. Unlike conventional application programs such as spreadsheets, data base, and accounting packages that generally automate tasks containing relatively simple logic, expert systems store millions of facts and thousands of rules and automate complex logic tasks. Expert systems provide users with the knowledge that human experts can acquire only through years of study and experience, and this knowledge is used by the systems to think, to reason, and to make recommendations.

Expert systems are already in use in various disciplines, performing a host of extremely sophisticated functions. Oil and gas producers use expert systems to determine the location of valuable minerals. Major university hospitals use expert systems to assist in the diagnosis of disease and to interpret medical test results. Car repair centers rely on expert systems to diagnose problems and guide diesel engine repairs.

In the accounting and auditing areas, expert systems are available to provide estate planning recommendations, to perform an analytical review, to identify areas of concern to the auditor, to interpret financial statements, and to analyze a company's allowance for bad debts. In addition, research projects are underway to determine what knowledge is necessary to make fundamental audit decisions and what factors cause expert auditors to outperform novices.

It should be emphasized that although expert systems will make many decisions that were once made by humans, this fact does not mean consultants will no longer be needed. Consultants will develop the databases and interact with the expert systems to develop information for the decision-making process.

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Expert systems can be a short cut to attaining the necessary competency level for offering a particular MAS. With many expert system products scheduled to make their debut in the coming years, firms must continually monitor any new offerings to see if they provide new opportunities.

Conclusion

Careful planning to identify opportunities and to match a firm's capabilities with these opportunities is the key to a successful MAS consulting practice. Blind expansion could be the seed for failure. Accounting firms should develop short-term and long-term strategies to market MAS. In developing a firm-wide MAS strategy, consideration should also be given to the opportunities on the horizon provided by developing technologies in personal computers, decision support software, and expert systems.

EXHIBIT 1: MANAGEMENT ADVISORY SERVICES OPPORTUNITIES

Accounting and Financial Management

General Accounting Systems Design and Installation
Cost Accounting System Design and Installation
Cash and Working Capital Management
Corporate Tax Planning
Financial Planning and Modeling
Profit Planning
Budgeting and Control Systems
Ratio Analysis

Personal Financial Planning

Income Tax Planning
Estate Planning
Personal Financial Plans

Litigation Support

Forensic Accounting
Expert Witness
Valuation
Antitrust
Divorce Accounting
Bankruptcy
Fraud Investigation

Computer Service (Information Management)

Personal Computer Hardware and Software Analysis
Information Needs Analysis
Management Information Systems
Systems Design and Implementation
Feasibility Analysis
Hardware and Software Evaluation
Project Control Systems
Office Automation
Clerical Methods and Procedures
Short- and Long-Range Planning
Data Securiity Reviews

Corporate and Business Planning (Strategic Management)

Objectives and Goal Definition
Short- and Long-Range Planning
Growth Strategies
Merger and Acquisition Analysis
Business Valuation

Operations Management

Forecasting Systems
Order Processing Systems
Material Requirements Planning
Production Planning and Quality Control
Inventory Management Systems
Facilities Requirements
Assess Operational Effectiveness
Review Operating Policies

Marketing Management

Marketing Information Systems
Sales Compensation Programs
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When It's Double Or Nothing In Assessing Audit Risk

By Janet L. Colbert

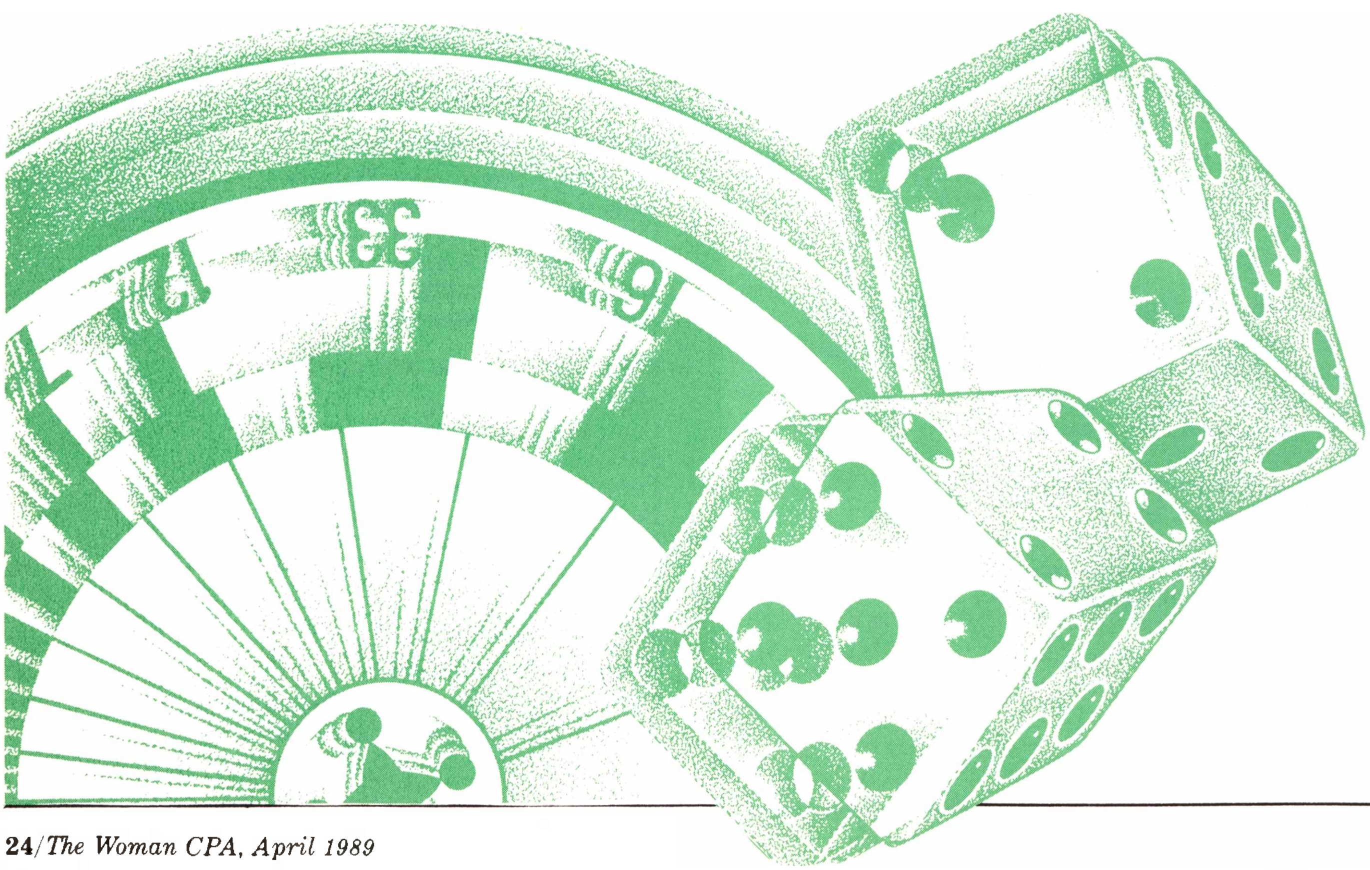
Introduction

In April 1988, the Auditing Standards Board issued Statement on Auditing Standards (SAS) 60 entitled "Communication of Internal Control Structure Related Matters Noted in an Audit" [AICPA, 1988]. The Statement requires the auditor to communicate significant deficiencies in the control structure, or "reportable conditions," to the client's audit committee.

Many matters that the auditor deems to be reportable conditions may also be factors that bear on the auditor's assessment of inherent risk. SAS 47, "Audit Risk and Materiality in Conducting an Audit" [AICPA, 1983], requires the auditor to consider inherent risk when planning the work for an individual account balance or class of transactions. Numerous factors may bear on the auditor's assessment of inherent risk. The purpose of this article is to explore the relationship between reportable conditions and inherent risk factors and to investigate how the conditions/factors that are common to both affect the work of the auditor.

Reportable Conditions

SAS 60 defines reportable conditions as matters that the auditor believes

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> . . . represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data . . . [para. 2].

Reportable conditions include matters which affect the three elements of the control structure: the control environment, the accounting system, or the specific control procedures.

Under SAS 60, the auditor is required to communicate reportable conditions that are found during the engagement to the audit committee or to individuals who have the authority and responsibility equivalent to that held by an audit committee. While communicating reportable conditions is beneficial to the client, it is not the primary objective of the audit, and users of the financial statements should be aware that auditors are obligated to report only those conditions found in the normal course of the audit engagement. The auditor is not required to perform special procedures to search for reportable conditions.

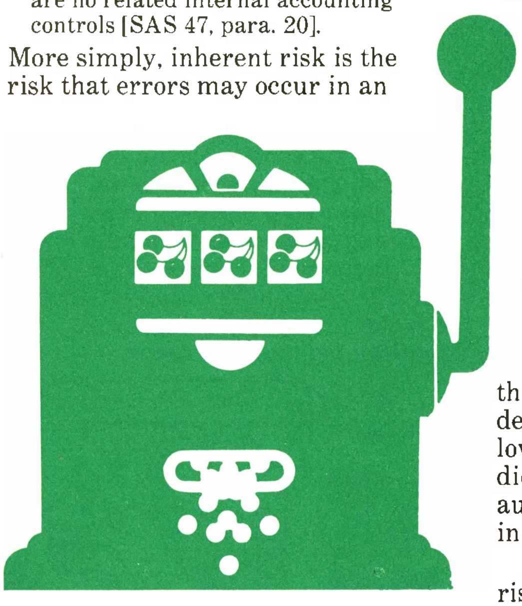
Reportable conditions can be grouped into three categories. The first, deficiencies in control structure design, includes such items as the application of accounting principles, the segregation of duties, and the system's output. The second category covers failures in the operation of the control structure such as evidence of failure to safeguard assets or evidence of intentional misapplication of accounting principles. The final category includes other items the auditor may believe indicate control-related deficiencies. Examples are the client's lack of objectivity in making accounting decisions and the absence of a sufficient level of control consciousness within the client's firm.

Inherent Risk Factors

Inherent risk is the

> . . . susceptibility of an account balance or class of transactions to error that could be material, when aggregated with error in other balances or classes, assuming there are no related internal accounting controls [SAS 47, para. 20].

More simply, inherent risk is the risk that errors may occur in an audit area without giving consideration to the effect internal controls may have on preventing or detecting the errors.



Inherent risk is one component of audit risk at the individual account balance or class of transactions level. The other risks comprising individual audit risk are control risk and detection risk. Control risk is the risk that once errors have occurred, they are not prevented or detected by the system of internal control. Detection risk is the risk that, given errors have occurred and were not detected by the system of internal control, these errors are not detected by the auditor.

Audit risk at the individual account balance or class of transactions level and its three components can be modeled as follows:

$$AR = IR \times CR \times DR$$

where

AR is audit risk,
IR is inherent risk,
CR is control risk,
DR is detection risk.

This model is derived from the multiplicative model of audit risk found in SAS 39, "Audit Sampling," and updated for the provisions of SAS 47.[1] It is intended to help the auditor plan the work in an audit area.

The model is manipulated as follows to aid the auditor in determining the nature, timing, and extent of testing in an audit area:

$$DR = AR/(IR \times CR)$$

In this format, the model shows that when inherent risk is high, detection risk must be limited to a low level (confidence must be high), dictating that more substantive audit procedures must be applied in the audit area.

The auditor assesses inherent risk by considering factors that bear on that risk. Inherent risk factors may be divided into those that affect many, or all, audit areas (pervasive factors) and those that affect a particular area (account-specific factors).

The factors can be classified into five groups: 1) the environment of the operating entity, 2) the structure of the entity, 3) the characteristics of management and the board of directors of the entity, 4) the financial position and accounting practices of the entity, and 5) auditor concerns and relations.

An example of a pervasive inherent risk factor in the first group is the state of the general economy [Colbert, p. 46]. A depressed economy may concern

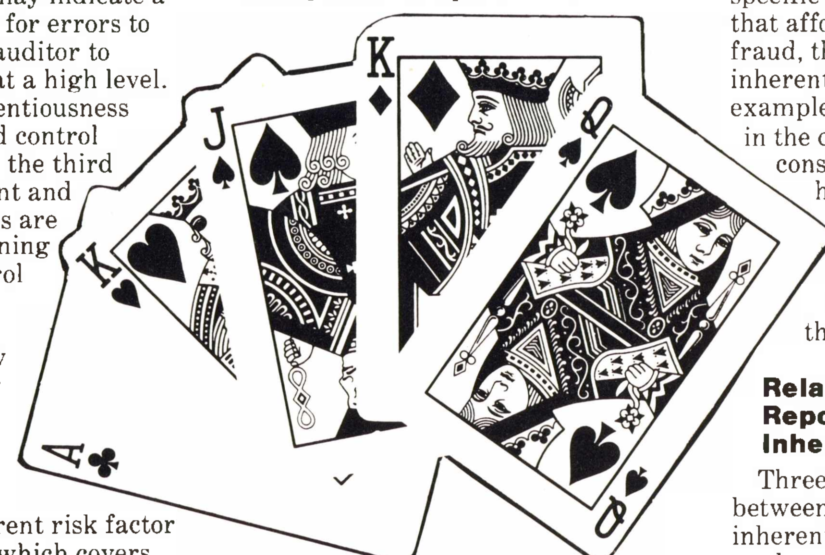
Under SAS 60, the auditor is required to communicate reportable conditions . . . to the audit committee . . .

the auditor and may indicate high inherent risk while a healthy, growing economy may allow the auditor to assess inherent risk at a low level. The second group is the structure of the entity, and one factor in the group is the complexity of the organization. A complex organization (many diverse product lines, various means of distribution, widely scattered locations) may indicate a higher susceptibility for errors to occur and cause the auditor to assess inherent risk at a high level.

The level of conscientiousness about accounting and control matters is a factor in the third group. If management and the board of directors are conscientious concerning accounting and control matters, the auditor will be able to assess inherent risk at a low level. Procedures for identifying mistakes in recording transactions and applying accounting principles is an inherent risk factor in the fourth group, which covers the entity's financial situation and accounting practices. If the client has established procedures for reviewing entry data and the procedures show that few mistakes are made, the auditor has evidence to indicate that a low inherent risk assessment may be appropriate. The fifth and final group of pervasive factors is auditor concerns and relations. One factor here is the implementation of recommendations of internal and external auditors. If recommendations are generally ignored, the auditor may feel management is not conscientious about accounting matters and assess inherent risk at a high level.

Account specific inherent risk factors fall into four categories: 1) management and personnel, 2) accounting matters, 3) accounting systems, and 4) miscellaneous matters. When assessing these factors, the auditor should consider them as they apply only to the particular account being examined.

The experience and training of management and personnel in the specific area under examination is a factor in the first category. If management and personnel,



particularly accounting personnel, are well-trained and experienced, the auditor may be able to assess inherent risk for the area at a low level. The second category covers items such as the history of errors in the area. If the audit area has experienced many errors in the past, the auditor may believe this indicates high inherent risk.

Only when a factor adversely affects inherent risk can it possibly be a reportable condition.

The third category, the accounting system for the area, includes segregation of duties. If an area has proper segregation of duties, the auditor may be able to judge inherent risk to be low. Miscellaneous factors, for instance, the opportunity for fraud, make up the final category of account specific factors. In an audit area that affords a high opportunity for fraud, the auditor may assess inherent risk to be high. For example, in judging inherent risk in the cash area, the auditor might consider a credit union, which has a large volume of cash transactions, to have higher inherent risk in the cash area than a firm in which cash is collected through a lockbox system.

Relationship Between Reportable Conditions And Inherent Risk Factors

Three aspects of the relationship between reportable conditions and inherent risk factors need to be explored:

- the categorization of some items as both reportable conditions and inherent risk factors
- the effect of the conditions/factors on the audit risk model
- the communication of

conditions/factors to the audit committee

Reportable Conditions/ Inherent Risk Factors

Several of the possible reportable conditions are also inherent risk factors. Consider, for example, that the "absence of a sufficient level of control consciousness within the organization" is a possible reportable condition. Earlier, it was stated that the "level of conscientiousness about accounting and control matters" by management and the board of directors is a pervasive inherent risk factor. Thus, "level of conscientiousness about control" is both a reportable condition and an inherent risk factor.

Another reportable condition that also bears on inherent risk is "evidence of manipulation, falsification, or alteration of accounting records or supporting documents." Inherent risk factors that parallel this condition are: "procedures to identify intentional wrongdoing" by management or the board of directors, "procedures to identify intentional or unintentional mistakes in recording transactions," and "motivation to misstate" (by management and personnel).

Other reportable conditions and related inherent risk factors are listed on page 29.

Note that inherent risk factors are stated in neutral terms while reportable conditions have a negative connotation. Only when a factor adversely affects inherent risk can it possibly be a reportable condition. For example, the inherent risk factor "objectivity in accounting decisions" is stated in neutral terms and the related reportable condition "evidence of undue bias or lack of objectivity by those responsible for accounting decisions" has a negative connotation. If management is objective in making accounting decisions, this has a positive effect; the auditor will tend to decrease the assessed level of inherent risk. If, however, management is not objective, the auditor will likely judge inherent risk to be higher; additionally, the item will be communicated as a reportable condition. Thus, factors must be at levels that cause inherent risk to be assessed as high to have the negative connotation of reportable conditions and consequently be communicated to the audit committee.

The Audit Risk Model

The relationship between reportable conditions and inherent risk factors is particularly significant when considering the audit risk model. Items that are both reportable conditions and inherent risk factors affect the model in a unique manner: the item bears on the auditor's assessment of both control risk and inherent risk.[2] Because reportable conditions represent significant deficiencies in the control structure, they are necessarily considered in the auditor's judgment of control risks. Reportable conditions cause control risk to be assessed at a high level. A reportable condition which is also an inherent risk factor will most likely lead to a high assessment of inherent risk. The reportable condition and the inherent risk factor are really the same item, but the condition/factor bears on two different components of the audit risk model for different reasons. Examples will clarify this.

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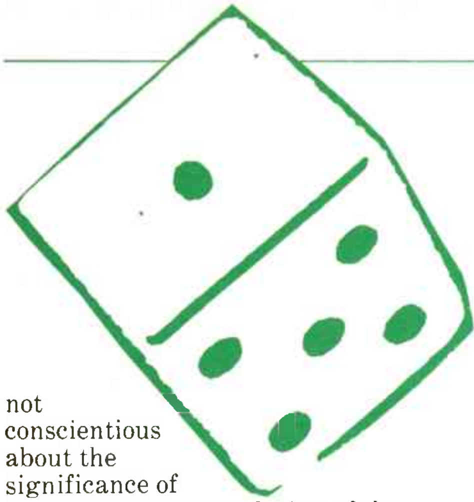
Consider this reportable condition: "evidence that employees or management lack qualifications and training to fulfill their assigned functions." The auditor may believe that there is a risk that such personnel may not adhere to the established control structure. Perhaps control procedures could be bypassed or performed incorrectly. In this situation, because the control system cannot be relied upon, the auditor will likely believe control risk is high.

Inherent risk factors that parallel this reportable condition are: "commpetency" and "experience and training" of management and personnel. If the auditor finds management and personnel are not as competent as they should be and if they lack experience and training, then the auditor may believe that there is a high risk that errors could enter that accounting area. Inherent risk is then assessed at a high level. Thus, one item may affect more than one component of the audit risk model, but for different reasons. The condition/factor bears on inherent risk because it may indicate that the accounting area is susceptible to errors. The condition/factor may affect the auditor's assessment of control risk because it may cause the auditor to suspect that the control structure may not be operating effectively.

Another example of a reportable condition that may also bear on inherent risk is the absence of a sufficient level of control consciousness within the organization. The corresponding inherent risk factor is the level of conscientiousness about accounting and control matters. If the client is



not conscientious about the significance of the functioning and design of the control structure, the auditor may decide to assess control risk at a high level. Similarly, if management is not conscientious concerning accounting and control matters, errors may have a greater chance of entering the system and the auditor would judge inherent risk to be high. One aspect of the condition/factor bears on the item entering the system and the other affects the risk of the system not preventing or detecting the error. These are two distinct phases in the accounting system; assessing a condition/factor in both phases is appropriate and is not double-counting.

Communication of Conditions/Factors

As mentioned earlier, the auditor is required to communicate reportable conditions to the audit committee. In entities that do not have an audit committee, the communication is made to individuals with a level of authority and responsibility equivalent to that delegated to an audit committee. Either written or oral communication is allowed. SAS 60 provides examples of wording that the auditor might use in a written communication.

Professional standards do not require the auditor to communicate inherent risk factors to the audit committee (or its equivalent). Nevertheless, because some inherent risk factors are also reportable conditions, they will necessarily be communicated to the client. Only reportable conditions are communicated to the client; no mention need be made that the item included as a reportable condition is also an inherent risk factor.

Conclusion

Reportable conditions and inherent risk factors are related in the following ways: 1) some reportable conditions are also inherent risk factors, 2) both reportable conditions and inherent risk factors affect the audit risk model, and 3) inherent risk factors that are also reportable conditions are communicated to the audit committee.

Several reportable conditions parallel factors that bear on the auditor's judgment of inherent risk. By their nature, reportable conditions necessarily affect the auditor's assessment of control risk. If a reportable condition is also an inherent risk factor, then two components of the audit risk model are affected. That is, one condition/factor bears on both inherent risk and control risk but for different reasons. When inherent risk and control risk are assessed at high levels, the audit risk model shows that the planned level of detection risk must be lower. Audit procedurees are then designed to provide the auditor confidence in order to limit detection risk to its planned low level.

SAS 60,"Communication of Internal Control Structure Related Matters Noted in an Audit," requires the auditor to communicate reportable conditions to the client's audit committee. Because some inherent risk factors are also reportable conditions, they will be communicated to the client (only as reportable conditions; the items need not be identified as inherent risk factors).

When the auditor locates a reportable condition, the audit is affected in three ways: 1) the condition must be reported to the audit committee, 2) the condition affects the judgment of control risk, and 3) the condition bears on the assessment of inherent risk if the condition is also an inherent risk factor. In order to comply with the new SAS and to plan an effective engagement, the auditor must consider all three effects when planning the audit.

FOOTNOTES

[1]SAS 39 presents a multiplicative model of audit risk; SAS 47 indicates that audit risk has three components but does not present them in a mathematical formula. The model given here is not meant to be used in a strict mathematical sense. Rather, it should aid in understanding the relationships of the components of audit risk.

[2]This is also true for items which are reportable conditions and business risk factors or factors which bear on planned audit risk.

REFERENCES

American Institute of Certified Public Accountants, *Statement on Auditing Standards No. 60*, "Communication of Internal Control Structure Related Matters Noted in an Audit" (AICPA, 1988).

__________, *Statement on Auditing Standards No. 47*, "Audit Risk and Materiality in Conducting an Audit" (AICPA, 1983).

Colbert, Janet, "Use the Concept of Inherent Risk — It Helps!" *The Internal Auditor*, (April 1987), pp. 45-58.

Related Reportable Conditions and Inherent Risk Factors

Reportable Condition	Inherent Risk Factor
Absence of a sufficient level of control consciousness within the organization	Level of conscientiousness about accounting and control matters
Evidence of undue bias or lack of objectivity by those responsible for accounting decisions	Objectivity in accounting decisions
Evidence that employees or management lack qualifications and training to fulfill their assigned functions	Competency of management and personnel Experience and training of management and personnel
Evidence of willful wrongdoing by employees and management	Procedures to identify intentional wrongdoing Procedures to identify intentional mistakes in recording transactions
Evidence of manipulation, falsification, or alteration of accounting records or supporting documents	Procedures to identify intentional wrongdoing by management or the board of directors Procedures to identify intentional or unintentional mistakes in recording transactions Motivation of management and personnel to misstate
Evidence of intentional misapplication of accounting principles	Procedures for identifying intentional mistakes in applying accounting principles Motivation of management and personnel to misstate

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